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Christopher Dean Olander

Cynthia L. Spell

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INTEREST RATE SWAPS: STATUS UNDER FEDERAL TAX AND SECURITIES LAWS

CHRISTOPHER DEAN OLANDER*
CYNTHIA L. SPELL**

I. INTRODUCTION AND BACKGROUND

A. Introduction

Participation in interest rate swap transactions has soared since the financing device was first used in 1982.¹ It is estimated that there is currently in excess of \$200 billion in principal amount of debt that is subject to interest rate swap transactions.² This is indeed phenomenal growth. Yet, given the relative simplicity and flexibility of these transactions (and particularly the financial benefit that inures to both parties of a swap), it is surprising that more corporations and financial institutions are not engaging in them. It is clear that many corporate treasurers, bankers, thrift institution executives, and lawyers do not yet know much about interest rate swaps. Even those who do participate in this new "market" have little appreciation of the uncertain tax consequences and securities law questions attending these transactions.

An interest rate swap is simply a financing technique whereby two parties exchange their interest payments with respect to an agreed-upon principal sum³ for a given period of time. Typically,

* B.A., The Johns Hopkins University, 1970; J.D., with honors, University of Maryland School of Law, 1973. Mr. Olander, a member of the law firm of Shapiro and Olander, Baltimore, Maryland, is a member of the Federal Regulation of Securities Subcommittee of the American Bar Association, the Securities Law Subcommittee of the Maryland State Bar Association, and the National Association of Bond Lawyers.

** B.A., with honors, St. Mary's College of Maryland, 1979; J.D., with honors, University of Maryland School of Law, 1985. Ms. Spell is an associate of the law firm of Shapiro and Olander, Baltimore, Maryland.

1. See McGoldrick, *The Interest Rate Swap Comes of Age*, INSTITUTIONAL INVESTOR, Aug. 1983, at 83.

2. Shirreff, *The Fearsome Growth of Swaps*, EUROMONEY, Oct. 1985, at 247. In 1983, one year after the introduction of the interest rate swap, the principal amount was already around \$20 billion. Jasper & Ross, *The Economics of Interest Rate Swaps*, in Interest Rate and Currency Swaps Program, Practising Law Institute 12 (Dec. 6, 1985).

3. This is usually referred to as the "notional" amount. Arnold, *How to Do Interest Rate Swaps*, HARV. BUS. REV., Sept.-Oct. 1984, at 96.

an interest rate swap involves the exchange of a variable-rate interest obligation for a fixed-rate interest obligation.⁴ Financial institutions and corporations use interest rate swaps as a means of transforming variable-rate liabilities into fixed-rate liabilities (or vice versa). Swaps are also used by institutions to obtain financing at a more favorable interest rate than is available in the conventional market.

Like many new financing techniques, interest rate swaps have not settled comfortably into the fabric of either the tax or the securities laws. This article discusses the tax and securities law issues involved in swaps and suggests preferred ways of resolving those issues. The article also describes the purpose of interest rate swaps; the financial objectives of using swaps in different circumstances; the structure of interest rate swaps; and new uses for swaps. The authors are aware that the conclusions reached regarding the status of swaps under federal tax and securities laws may not be popular, yet we are compelled by the nature of these transactions and the treatment of analogous financing devices under the law to reach the conclusions in this article.

B. Background

Interest rate swaps developed from an older, international financing technique known as the currency swap.⁵ In its simplest

4. Variable-rate interest differs from fixed-rate interest in that the interest rate on the loan can fluctuate, depending on an index. See *infra* notes 32-40 and accompanying text. Variable-rate interest is also called floating-rate interest. The terms variable-rate liability and fixed-rate liability refer to obligations to pay out interest at a variable or fixed rate, respectively. Similarly, a variable- or fixed-rate asset is an asset which produces revenue at a variable or fixed rate, respectively.

5. A currency swap entails the exchange of funds in one currency for funds in another currency, with an agreement to re-exchange the currencies at a given date in the future. For a discussion of currency swaps and other international financing techniques, see Henrey, *Financing of International Business Activities, Including the Use of Swaps and Deep Discount Bonds*, 42 INST. ON FED. TAX'N 31-1 (1984); MERRILL LYNCH CAPITAL MARKETS, CROSS-CURRENCY FINANCING TECHNIQUES.

For general information concerning interest rate swaps and a brief history, see Arnold, *supra* note 3; Oberg & Parliment, *Swaps Offer a Weapon in the Battle Against Interest Rate Risk*, SAVINGS INSTITUTIONS, Nov., 1983, at 78; Stieber, *Rate Swaps Stabilize Costs, Aid in Quest for Profitability*, Savings and Loan News, Mar. 1983, at 78, 78; Euromoney, Special Financing Report: Swap Financing Techniques (B. Antl ed. 1983); Interest Rate and Currency Swaps Program, Practising Law Institute (Dec. 6, 1985); R. Kopprasch, J. Macfarlane, D. Ross & J. Showers, *The Interest Rate Swap Market: Yield Mathematics, Terminology and Conventions* (Salomon Brothers Inc. 1985) [hereinafter cited as Kopprasch].

form, a swap involves one borrower of funds exchanging its variable-rate interest payment obligation for another borrower's fixed-rate interest payment obligation. Neither party exchanges principal payments. The underlying contractual obligations to the parties' respective lenders is not affected in any way; the swap transaction contractually binds only the two borrowers.

Interest payments between the parties to a swap can be made on either a *gross* or *net* basis. Under a *gross* payment scheme, each party pays to the other the gross amount of the other's interest payment, which the other then pays to its respective lender. Typically, this arrangement is used when the parties' interest payments fall due on different dates. But if the interest payment dates are the same, the parties generally do not swap two interest payments in a literal sense, but *net* their payments, so that the swap party assuming the higher interest payment obligation simply remits to the other party the net difference. Payments on a gross basis are more likely where the swap is related to preexisting debt, whereas net payments are more common when the incurrence of the underlying debt is planned with the swap in mind.⁶

One of the most advantageous features of interest rate swaps is their flexibility, and it is this flexibility that has generated countless variations of the original, simple transaction.⁷ As a result, interest rate swaps can be tailored to unusual or specialized circumstances.

II. DIFFERENT GOALS ACHIEVED BY INTEREST RATE SWAP TRANSACTIONS

Interest rate swaps can serve any one or more of three goals: (1) hedging to reduce interest rate risk, e.g., by matching fixed-rate assets to fixed-rate liabilities and variable-rate assets to variable-rate liabilities on an existing balance sheet; (2) obtaining access to new capital at better rates than would otherwise be available; and (3) speculating on movements in interest rates by constantly adjusting interest payments (a technique referred to as "asset/liability

6. See Kopprasch, *supra* note 5. The practice of netting payments has gone far beyond the netting of payments in a single swap transaction. When the same two entities are parties to more than one swap transaction, they frequently net the stream of cash flows of all swaps to which they are parties. Further, there is a developing trend to net all payments to all parties under the master swap agreements recently devised by investment banking firms. Remarks of Thomas Jasper at the Practising Law Institute Program on Interest Rate and Currency Swaps, in New York City (Dec. 6, 1985) [hereinafter cited as Jasper]. Master swap agreements are discussed *infra* note 42.

7. In fact, the simple swap described above is now called a "plain vanilla swap." See Kopprasch, *supra* note 5, at 4; McGoldrick, *supra* note 1, at 84-85.

management").⁸

A. *The Interest Rate Swap as a Hedging Device*

A common objective of financial institutions or corporations is to match variable-rate assets to variable-rate liabilities and fixed-rate assets to fixed-rate liabilities in order to protect against the consequences of changing interest rates.⁹ That is, financial planners seek to maintain a comfortable margin between the rate of interest paid *in* to the institution as revenue and the rate of interest to be paid *out* by the institution to its creditors. If an institution has a greater amount of variable-rate liabilities than variable-rate assets, interest rates on variable-rate liabilities may rise without a corresponding increase in interest income from fixed-rate assets.¹⁰ Interest rate swaps can narrow the spread that may result from rising interest rates and, therefore, act as a hedge.

To illustrate the manner in which interest rate swaps can reduce interest rate risk, assume the situation of a savings institution with a simplified balance sheet that appears as follows:¹¹

Assets:	\$10 M Variable-rate at 10%	=	\$1,000,000
	\$90 M Fixed-rate at 11%	=	<u>9,900,000</u>
			<u>10,900,000</u>
Liabilities:	\$40 M Variable-rate at 9%	=	3,600,000
	\$60 M Fixed-rate at 10%	=	<u>6,000,000</u>
			<u>9,600,000</u>
	Net Interest Income	=	<u>\$1,300,000</u>

If interest rates were to rise by 2%,¹² the following would be the effect on this savings institution's balance sheet:

Assets:	\$10 M Variable-rate at 12%	=	\$1,200,000
	\$90 M Fixed-rate at 11%	=	<u>9,900,000</u>
			<u>11,100,000</u>
Liabilities:	\$40 M Variable-rate at 11%	=	4,400,000
	\$60 M Fixed-rate at 10%	=	<u>6,000,000</u>

8. See Grant, *Why Treasurers are Swapping Swaps*, EUROMONEY, Apr. 1985, at 19.

9. See, e.g., Stieber, *supra* note 2; Oberg & Parliment, *supra* note 5.

10. See generally Oberg & Parliment, *supra* note 5 (discussion of critical imbalance of rate-sensitive liabilities and assets).

11. These illustrations are modeled after the example found in Oberg & Parliment, *supra* note 5, at 78, 80. Interest rate swaps by thrift institutions are almost always collateralized by mortgages or deeds of trust because of the credit standing of most institutions.

12. In financial jargon, this would be referred to as a rise of 200 basis points (100 basis points = 1%).

$$\begin{array}{rcl} & & 10,400,000 \\ \text{Net Interest Income} & = & \underline{\underline{\$ 700,000}} \end{array}$$

That is, a 2% rise in interest rates results in a \$600,000 decrease in interest income for the savings institution. A further example shows what happens to the foregoing simplified balance sheet if interest rates were to rise by 3%:

$$\begin{array}{rcl} \text{Assets:} & \$10 \text{ M Variable-rate at } 13\% & = \$1,300,000 \\ & \$90 \text{ M Fixed-rate at } 11\% & = \underline{9,900,000} \\ & & \underline{11,200,000} \\ \text{Liabilities:} & \$40 \text{ M Variable-rate at } 12\% & = 4,800,000 \\ & \$60 \text{ M Fixed-rate at } 10\% & = \underline{6,000,000} \\ & & \underline{10,800,000} \\ \text{Net Interest Income} & = & \underline{\underline{\$ 400,000}} \end{array}$$

A 3% increase in interest rates has now reduced interest income by \$900,000 (\$1,300,000 less \$400,000).

By means of an interest rate swap, this savings institution could reduce its variable-rate debt, substituting fixed-rate debt. A rise in interest rates would result in a smaller decrease in net interest income than would be the case without a swap in place. The institution would have matched its substantial fixed-rate assets to fixed-rate, rather than variable-rate, liabilities.

Note, however, that the institution would probably have to pay a higher rate for fixed-rate financing than for its initial variable-rate obligation. Thus, the interest rate swap would initially decrease the institution's net interest income. For many savings institutions, however, the trade-off is acceptable—even desirable—because the swap guarantees a certain amount of net interest income, no matter how high or low interest rates go. The decrease in potential interest income is more than offset by the value of stability and longevity in the matching of assets and liabilities.¹³

To illustrate the foregoing, assume that the savings institution swaps \$20,000,000 of its variable-rate debt for fixed-rate debt at 10.5%. If interest rates did not change, the savings institution's simplified balance sheet would appear as follows:

13. See Oberg & Parliment, *supra* note 5, at 78-79.

Assets:	\$10 M Variable-rate at 10%	=	\$1,000,000
	\$90 M Fixed-rate at 11%	=	<u>9,900,000</u>
			10,900,000
Liabilities:	\$20 M Variable-rate at 9%	=	1,800,000
	\$20 M Swap Funds at 10.5%	=	2,100,000
	\$60 M Fixed-rate at 10%	=	<u>6,000,000</u>
			9,900,000
Net Interest Income		=	<u>\$1,000,000</u>

The immediate cost of this transaction to the institution is \$300,000 (net income of \$1,300,000 before the swap minus net income of \$1,000,000 after the swap). However, if interest rates were to rise by 2% after the interest rate swap, the institution's simplified balance sheet would be as follows:

Assets:	\$10 M Variable-rate at 12%	=	\$1,200,000
	\$90 M Fixed-rate at 11%	=	<u>9,900,000</u>
			11,100,000
Liabilities:	\$20 M Variable-rate at 11%	=	2,200,000
	\$20 M Swap Funds at 10.5%	=	2,100,000
	\$60 M Fixed-rate at 10%	=	<u>6,000,000</u>
			10,300,000
Net Interest Income			<u>\$ 800,000</u>

This shows the beneficial hedging value of an interest rate swap. The net interest income after the swap of \$800,000 reflects a \$200,000 decrease in interest income assuming a 2% rise in interest rates. Without an interest rate swap and with a 2% increase in interest rates, the decrease in interest income would be \$600,000. Therefore, a savings of \$400,000 results from the interest rate swap. The savings is increased to \$600,000 if interest rates rise by 3%.

The table below summarizes the results of the hypotheticals above. It compares the consequences of engaging in a swap transaction to the results of engaging in no swap transaction, based on the assumptions shown above, and assuming that interest rates remain constant, increase by 2%, and increase by 3%.

	<u>No Swap</u>	<u>With Swap</u>
No Change in Interest Rates:		
Net Interest Income	\$1,300,000	\$1,000,000
2% Increase in Interest Rates:		
Net Interest Income	<u>\$ 700,000</u>	<u>800,000</u>
Decrease in Interest Income	<u>\$ 600,000</u>	<u>\$ 200,000</u>

3% Increase in Interest Rates:

Net Interest Income	\$ 400,000	700,000
Decrease in Interest Income	<u>\$ 900,000</u>	<u>\$ 300,000</u>

The foregoing demonstrates that an interest rate swap offers a mechanism for matching fixed-rate liabilities to fixed-rate assets and variable-rate assets to variable-rate liabilities as an effective hedge against changing interest rates.¹⁴

B. The Interest Rate Swap as a Financing Vehicle

In addition to reducing exposure to changes in interest rates, the interest rate swap may also provide an alternative source for fixed- or variable-rate debt financing by permitting an institution or corporation to gain indirect access to sources of capital otherwise unavailable to it.¹⁵ To accomplish this, parties that have different credit risks in different financing markets must be matched. The parties are then in a position to trade their comparative financing advantages with each other. Parties have different financing advantages available because, although the interest rate differential is slight between high-rated and low-rated borrowers in the floating-rate market, the differential between high-rated and low-rated borrowers in the fixed-rate market can be 500 basis points or more.¹⁶ The result is that a high-rated borrower that has access to very advantageous rates in the fixed-rate market does little better than a

14. Though the example only shows the benefits of switching from variable-rate to fixed-rate liabilities to hedge against a rise in interest rates, the same principles apply when an institution hedges against a drop in rates by switching from fixed- to variable-rate liabilities. Likewise, the institution might hedge against an increase in rates by swapping fixed- for variable-rate assets. This is known as an asset-driven swap. Walmsley, *Understanding Interest Rate Swaps*, THE BANKERS MAGAZINE, July-Aug. 1984, at 46.

15. See McGoldrick, *supra* note 1, at 83; *A Back Door to Fixed-Rate Loans*, BUS. WK., Dec. 13, 1982, at 85. One example of this is the use of an interest rate swap to fund long-term, fixed-rate assets with short-term, floating-rate liabilities, or variable-rate assets with fixed-rate liabilities. For example, the Student Loan Marketing Association (Sallie Mae) once needed a source of financing for assets that included floating-rate student loans. Although relatively inexpensive fixed-rate financing was available to Sallie Mae, it needed variable-rate financing to insulate itself from the effects of falling interest rates. Therefore, Sallie Mae funded its variable-rate assets by entering into a fixed-rate obligation and then swapping its fixed rate for a variable rate. See Stieber, *supra* note 2.

16. In the following discussion, the terms "high-rate borrower" and "low-rated borrower" refer to the borrower's credit rating and should not be confused with the rate of interest that the borrower is paying. In fact, it will always be the case that a low-rated borrower must pay higher interest rates. In addition, banks generally prefer not to lend money at fixed rates to customers with low credit ratings. Fixed-rate lending is riskier than variable-rate lending; therefore a bank must limit the size of its fixed-rate portfolio. Consequently, the bank prefers to reserve its fixed-rate loans for its better (higher rated) customers. If it does lend to a low-rated customer at a fixed rate, the bank will probably

low-rated borrower in the floating-rate market. An interest rate swap gives a low-rated borrower access to better rates in the fixed-rate market. Similarly, an interest rate swap gives a high-rated borrower access to better rates in the floating-rate market.

An additional incentive for a high-rated borrower is that a low-rated borrower may be required to pay the high-rated borrower a "spread"¹⁷ for access to the high-rated borrower's fixed-rate financing. That is, a low-rated borrower with variable-rate debt may enter into a swap in which the low-rated borrower assumes a high-rated borrower's fixed-rate payments, and in addition pays a spread of so many basis points to the high-rated borrower. The spread reduces the high-rated borrower's new, variable-rate payments, resulting in a less expensive rate of borrowing in the floating-rate market than would otherwise be available.

In some circumstances, the low-rated borrower may not even have to pay a spread to the swap partner. For example, if the high-rated borrower entered into a long-term fixed-rate obligation at a time when interest rates were relatively high,¹⁸ the high-rated borrower may simply want to extricate itself from its current position by swapping for a lower variable interest rate. The spread is, so to speak, built into the transaction.

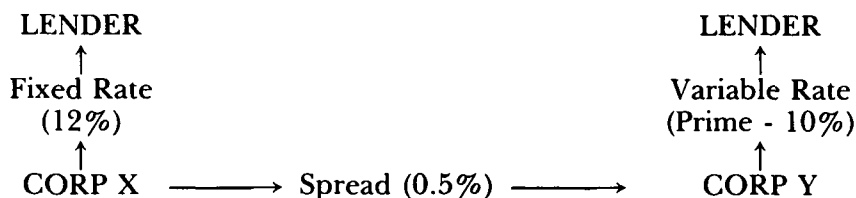
To illustrate the foregoing, assume that a low-rated corporate borrower (Corporation X) is seeking long-term fixed-rate financing, but that such financing is only available at 3% above the prime rate, while variable-rate financing is available at the prime rate. Further assume that the prime rate is 10%. A high-rated corporation (Corporation Y), on the other hand, has access to fixed-rate debt at 12% but would prefer floating-rate debt to fund its rate-sensitive assets. After agreeing to enter into an interest rate swap transaction with a spread of fifty basis points to be paid to Corporation Y, each party borrows the agreed-upon amount of principal from its respective lending source. Thereafter (or perhaps simultaneously), the high-rated borrower agrees to pay the low-rated borrower's interest payments at the variable rate. The low-rated borrower agrees to pay

charge a substantially higher interest rate than it would charge the better rated borrowers. In short, the low-rated borrower either lacks access to fixed-rate financing or must pay substantially higher rates to obtain it from a bank.

17. A spread is the additional amount, expressed as a percentage of the principal amount, that a low-rated borrower is willing to pay the high-rated borrower as an incentive and as additional compensation for entering into the swap.

18. For example, in the early 1980s, long-term interest rates of 15-16% were not uncommon even for high-rated borrowers. By 1985 however, the long-term rates averaged in the 11-12% range.

the high-rated borrower's interest payments plus a spread. The net effect of the swap is illustrated by the following:



The result of the above interest rate swap transaction is that low-rated Corporation X is able to obtain long-term fixed-rate financing at 12.5% rather than 13%. The high-rated Corporation Y is able to obtain variable-rate financing at a half point below the prime rate because, although it must pay the prime rate, it is receiving 0.5% from Corporation X.

C. *The Interest Rate Swap as a Means of Managing Liabilities*

Interest rate swaps and their progeny, the mirror swaps,¹⁹ are being used increasingly for liability management.²⁰ A mirror swap is a technique developed to reverse or modify the terms of a swap transaction. Both devices enable an institution constantly to readjust its balance sheet in order to take advantage of changes in interest rates and thereby "fine tune" short- and medium-term corporate debt.²¹

Many corporate finance officers do not consider it at all risky to "do and undo" swaps routinely. Those who share this approach believe that to leave a swap in place without constantly reassessing its usefulness is itself risky and constitutes a speculation on the movement of interest rates.²² Others never unwind a swap transaction, on the theory that continually trading swaps is unnecessarily risky and unwarranted if the objective for which the swap was originally entered into was achieved.²³ It would seem that these differing views reflect not so much the nature or characteristics of swaps and

19. See *infra* notes 44-46 and accompanying text.

20. See Grant, *supra* note 8.

21. The practice of trading swaps, although growing in popularity, is by no means a routine method of liability management at most U.S. corporations. Some "corporations avoid it because they lack the manpower to manage debt, or because senior management does not devolve enough authority for treasurers to trade swaps." *Id.* at 23.

22. "'It's speculation to stay in a swap without doing anything'" *Id.* at 19 (quoting Jean Reboul, treasurer of Gaz de France).

23. "'We take business risks in the production and marketing of computers; since we are in a volatile business we don't want to take extra risks in the financial sphere.'" *Id.* (quoting Jon Rotenstreich, treasurer of IBM).

mirror swaps as significant differences in corporate fiscal outlooks.²⁴

III. THE MECHANICS OF AN INTEREST RATE SWAP TRANSACTION

A. *Matching the Parties*

After an entity decides to engage in an interest rate swap, the next step is the selection of an appropriate counterparty. This requires the matching of two parties with opposite financing needs and financing advantages. One example of an appropriate matching of parties would be a United States savings and loan institution and a Japanese or European bank. The savings and loan institution can generate fixed-rate mortgage loans, but it must obtain most of its funds on a floating-rate basis.²⁵ The foreign bank normally lends in the Euromarket at a floating rate, while it can borrow through Eurobonds at fixed rates.²⁶ Another example would be a relatively low-rated public utility that receives fixed revenues and a large United States lending institution or a high-rated industrial corporation seeking floating-rate financing at below the prime rate of interest.

In many cases, a broker is used to find appropriate swap counterparties. The broker can serve in the transaction as either an agent for one or both of the parties or as a principal. As agent, the broker merely acts as an intermediary, assisting the parties in finding one another and in negotiating the terms of the swap, for which it receives a customary brokerage commission.²⁷ In transactions in which a broker acts as principal, the broker actually serves as the counterparty to the transaction: if one party defaults under the swap agreement, the broker will continue making the required payments to the nondefaulting swap partner.²⁸ Investment and commercial

24. The largest industrial corporation in the world, Exxon, has never even entered into an interest rate swap; other companies, such as IBM, use the interest rate swap somewhat conservatively; while even the smaller savings and loan institutions have used the device routinely. See Grant, *supra* note 8, at 24.

25. Savings and loan institutions generally do not have the requisite creditworthiness to borrow funds at sufficiently low fixed rates to permit them to fund fixed-rate loans on competitive terms.

26. Eurobonds are debt securities offered by a U.S. corporation in Europe (usually through its foreign subsidiary), payable in U.S. dollars. The Eurobond market currently is the largest source for the fixed-rate side of interest rate swaps.

27. The customary commission is usually 0.10% to 0.25% of the notional principal amount.

28. In this regard, the broker-as-principal transaction strongly resembles the type of credit enhanced swap where a third party issues a letter of credit. See *infra* notes 52-54 and accompanying text. In both arrangements, a third party insures against default by one of the swap parties.

banks that are active in the swap market frequently will engage in a swap transaction as principal with the intention of "selling" their swap position at a later time.²⁹

B. Structuring an Interest Rate Swap Transaction

An interest rate swap transaction requires careful attention to the index chosen to determine the variable-rate payments,³⁰ and to the fixed rate, the termination clauses, and the collateral or credit enhancement that may be required. Beyond these basic business terms, which are uniquely tailored to the needs of the parties, the remaining details are negotiated and documented by counsel in the swap agreement.

1. *Notional Principal Amount.*—The first interest rate swap transactions were based upon notional principal amounts ranging from \$25,000,000 to \$50,000,000. The more recent trend is toward "mini-swap" transactions which range in size from \$10,000,000 to \$15,000,000.³¹ The size of transactions hitherto has largely been a consequence of the size of the swap participants: there is no theoretical minimum size, especially in view of the low transaction costs. This trend toward smaller transactions makes the interest rate swap feasible for numerous additional financial institutions and corporations. Mini-swaps allow smaller institutions to engage in interest rate swaps and allow larger institutions to use swaps of various sizes, with different indexes and maturities, with a far broader range of financial institutions and corporations. The amount of principal to be used in a swap transaction might be based upon the amount of the corporation's or financial institution's assets that are to be matched with a corresponding variable- or fixed-rate liability, or upon the amount of principal the corporation or financial institution wishes to borrow in conjunction with a simultaneous interest rate swap transaction. Although the principal amounts of debt upon which the swap transaction will be based must be the same, no principal payments are exchanged and no principal repayment obligation is incurred by the other party to the swap transaction.

29. Grant, *supra* note 8, at 24; see also McGough, *Scratch My Greenback*, FORBES, July 18, 1983, at 129 (focusing on behavior of Salomon Brothers).

30. See *infra* notes 39-41 and accompanying text.

31. See Oberg & Parliment, *supra* note 5, at 81. Participants in the market believe that there is sufficient liquidity in the secondary market to support swaps of between \$2 million and \$1 billion in size, with maturities between one and twelve years. Jasper, *supra* note 6.

2. *Index.*—The choice of the variable rate index is perhaps the most crucial decision to be made in structuring an interest rate swap transaction. The interest index selected by the parties should be geared to the variable rate that the one swap partner is already obligated to pay. This decision should also take into account the variable rate that the party agreeing to pay variable-rate interest is seeking to hedge with the swap transaction. Historically, the most commonly used indexes³² include LIBOR,³³ the prime rate,³⁴ the Treasury bill interest rate,³⁵ the certificate of deposit rate,³⁶ the commercial paper rate,³⁷ the federal funds rate,³⁸ and the bankers acceptance rate.³⁹ These different variable rate indexes seldom move in perfect tandem with each other. Consequently, a party agreeing to pay a variable rate of interest for the purpose of hedging the variable rate it is earning on its assets will want to ensure that the rates are either based on the same index or that the indexes have equal or nearly identical volatility.⁴⁰ The benefits of the hedge

32. The variable rate indexes described *infra* notes 33-39 are normally found in H.15(519), a weekly statistical release published by the Board of Governors of the Federal Reserve System. LIBOR can also be found on the display designated as page "LIBO" on the Reuters Monitor Money Rates Service. The International Swap Dealer's Association, a newly formed industry association currently with 42 members, has created a reference book containing standard definitions of terms frequently used in swap agreements, known as the International Swap Dealers Association, Inc. Code of Standard Wording, Assumptions and Provisions for Swap (1985) [hereinafter cited as ISDA Code]. The ISDA Code permits a determination of rates either through reference to such primary sources or by taking the mean of the applicable offered rate by three primary institutions offering the particular rate.

33. LIBOR (London Inter-Bank Offered Rate) is probably the most popular floating-rate index in Europe and perhaps the world. Market participants estimate that 75% of all interest rate swaps are based on LIBOR, 15% on the commercial paper rate, and 10% on the other indexes. Jasper, *supra* note 6.

34. The prime rate is the rate quoted by banking institutions to their highest credit-rated borrowers.

35. Ninety-one day "T-bills" are short-term debt securities issued by the United States Treasury.

36. Certificates of deposit are obligations of commercial banks or other lending institutions. The quoted rate is normally the offering yield in the secondary market for one-month certificates of deposit in blocks of \$1 million or more.

37. The commercial paper rate usually refers to the rate for dealer-placed commercial paper with a maturity of 90 days, as reported in H.15 (519).

38. The federal funds rate is the rate for overnight loans among financial institutions.

39. The bankers acceptance rate is the discount rate in the secondary market for bank credits created to finance trade.

40. For a comparison of different floating interest rate indexes, see Sperantas & Hellmers, *Financing Real Estate with Interest Rate Swaps*, REAL EST. REV., Spr. 1984, at 65; Stieber, *supra* note 2.

transaction can be destroyed by hedging one interest rate with another that does not move with it.

Furthermore, even if the index is the same for the underlying debt and the interest rate swap, a difference in interest payment dates can present a risk to the parties. If the index rate differs on the respective interest due dates, the result can be the same as when two different indexes are used.⁴¹

3. *Spread*.—An interest rate swap is rarely a simple exchange of interest payments. A significant incentive for the fixed-rate borrower to enter into a swap transaction is the profit it can generate by obtaining the agreement of the variable-rate borrower to pay an additional number of basis points as an incentive for exchanging its favorable fixed rate. Thus, another important point to be negotiated is the amount of the spread.

4. *Documentation*.—Because an interest rate swap transaction entails no exchange of principal, the required documentation is much less complicated than that of a traditional loan transaction. Swap agreements are typically less than fifteen pages long; in some cases they are drafted after the swap is consummated so as not to delay the transaction. The interest rate swap is documented in a contract that includes definitions of the fixed and floating rates, mechanics of payment at settlement, provisions in case of default, termination provisions, and any required covenants by the parties.⁴²

41. A trend has developed in the last year with respect to the selection of fixed and variable rates that may now represent an industry standard: paying a fixed rate at a number of basis points over the T-bill rate against a floating rate based on six-month LIBOR. For example, on January 1, 1985, Salomon Brothers quoted seven-year swaps at 45 basis points over the T-bill rate against six-month LIBOR, flat (without a spread). Thus, if a borrower approached Salomon Brothers offering six-month LIBOR, the investment bank would provide a fixed rate of interest for seven years at 45 basis points above the then current T-bill rate. Conversely, if a borrower wanted to swap fixed interest for floating interest, Salomon Brothers might require a fixed rate equal to the Treasury rate plus 45 basis points to offer the borrower a floating rate at six-month LIBOR. See Grant, *supra* note 8.

42. The ISDA Code, *supra* note 32, has created and will continue to create a trend toward uniformity of documentation, thus leaving to the parties the task of negotiating covenants, early termination, collateral, and credit enhancement provisions. Documentation of interest rate swaps usually takes one of three forms. The first is the stand alone swap agreement in which a single transaction is documented. The second is the swap agreement for a transaction involving collateral. This agreement refers to one of two different ancillary agreements: a security agreement or, for marketable securities, a pledge agreement. The third form of documentation is relatively new and is used almost exclusively by investment banks. It is a master swap agreement under which literally dozens of swaps are effectuated. The only documentation used for each separate

If an intermediary is used, the agreement spells out that the intermediary will continue to make payments in the event of default by one of the parties.

Swap contracts normally involve a termination clause pursuant to which a termination fee is paid to protect either institution should the other fail to make an interest payment, or the defaulting party agrees to indemnify the other for its "loss." Indemnification provisions, however, are by nature vague and may increase a party's risk of being inadequately compensated for the other party's default.

By contrast, assuming the defaulting party is the lower rated borrower, specific termination payments are usually expressed either as an "agreement value" or a "formula value." "Agreement value" is a method whereby one of the swap parties, or a third party, obtains bids in the secondary swap market for the price at which the swap can be "bought." The cash payment that the defaulting party would be required to pay to "sell" the swap is instead paid to the nondefaulting party as the termination payment. A typical formula requires the defaulting party to pay the sum of the present values of future payments, assuming those payments to be based on an interest rate expressed as the difference between the rate in the swap agreement and the current "market" rate. One concern over formula termination payments is that a court could view them as liquidated damages in the form of a penalty because there is a secondary market available to obtain an actual measure of damages. Another concern with this method is that, although the discount rate for computing present value on the fixed-rate side of the swap is relatively easy to ascertain, it is uncertain on the variable-rate side of the swap.

Collateral or a letter of credit may be required by the parties to secure the payment of the termination fee or indemnity payment. Such an arrangement would require additional documentation typical of a secured or letter of credit transaction.⁴³

Counsel is often asked to render an opinion in interest rate swap transactions, especially when the client is engaging in a swap transaction with a particular counterparty for the first time, when the counterparty is dealing with the law of counsel's jurisdiction for

transaction is a "term sheet" which contains a summary of only the most essential economic swap terms peculiar to the individual transaction. *See* Interest Rate and Currency Swaps Program, Practising Law Institute (Dec. 6, 1985).

43. In its simplest form the letter of credit side of the transaction involves a rather complex reimbursement agreement between the credit bank and the party for whose benefit the letter of credit is being issued, in addition to the letter of credit itself.

the first time, or when the client is in a highly regulated industry such as a public utility. The opinion covers the customary issues of enforceability, due authorization, and lack of conflict with existing statutes and contracts. In addition, counsel in a foreign jurisdiction is usually requested to state in the opinion that payments under the swap are not subject to withholding taxes. Counsel may also be asked to opine specifically on the enforceability of termination payment provisions.

C. Neutralizing an Interest Rate Swap

Not surprisingly, a versatile new financing technique such as the interest rate swap will yield numerous variations on the original theme. Corporate treasurers and financing institutions have developed methods to reverse, or modify the terms of, swap transactions to take into account changes in the swap party's balance sheet, movements in interest rates, and fluctuations in the credit of swap partners. The primary techniques for doing so are the reverse or "mirror" swap, the swap sale, and the swap "close-out."⁴⁴

In the mirror swap transaction, the original interest rate swap remains untouched and the borrower desiring "out" continues its obligations under it. The borrower neutralizes its position, however, by engaging in a second transaction that is a mirror image of the first swap transaction. For example, if the party desiring to unwind a previous swap is receiving variable-rate interest payments and making fixed-rate interest payments, it would enter into a new swap transaction with a third party (not necessarily with the knowledge of the first swap partner) in which it would make variable-rate interest payments and receive fixed-rate interest payments.

Ideally, the maturity date, periodic payment dates, and variable interest rate index of the mirror swap will coincide precisely with the original swap. Since a variable rate will fluctuate, the variable-rate side of the mirror swap will completely neutralize the variable-rate side of the first swap if both variable rates are tied to the same index. Nevertheless, there is no assurance that the fixed rate will be the same as that which prevailed at the time of the original swap. Consequently, the fixed-rate side of the transaction will produce a profit or loss depending upon whether the fixed rate of the mirror swap is

44. For a discussion of mirror swaps, swap sales, and swap close-outs, see Grant, *supra* note 8; *Scrambling to Find New Markets for Interest Rate Swaps*, BUS. WK., May 9, 1983, at 118; Henderson, *The Constraints on Trading Swaps*, EUROMONEY, May 1985, at 67; Interest Rate and Currency Swaps Program, Practising Law Institute (Dec. 6, 1985).

greater or lesser than the fixed rate of the original swap, and whether the borrower is the payor or recipient of the higher payment. Even when a party neutralizes the original swap, it has entered into a second transaction and assumed a second credit risk of default by the mirror swap counterparty.

In a swap sale, the swap position is assigned to the purchaser, or assignee. The original party has more than neutralized the terms of the first swap; it is taken out of its swap position completely. Further, any profit on the sale is realized immediately and not over the life of the swap, as is the case with a reverse swap.

In a swap close-out, the parties to the original swap simply agree to terminate the contract. The primary disadvantage to this arrangement is that it requires the involvement of the original swap counterparty.

Corporate treasurers disagree about the desirability of trading swaps through mirror transactions to manage debt. More aggressive corporate money managers seem more than anxious to assess continually the intrinsic value of existing interest rate swaps in order to identify and possibly reverse "unprofitable" ones.⁴⁵ There has developed, as a result, a significant "market" for interest rate swaps, replete with elaborate pricing mechanisms.⁴⁶

D. Risks Inherent in Swap Transactions

The primary risk associated with an interest rate swap is default by the counterparty to the swap. If the borrower is a payee of the net swap amount, a default eliminates the net payment as a source of income. For the net payor as well as the net payee, the default "unwinds" the swap and eliminates the advantage originally gained by entering into the transaction. Since the parties had rearranged the interest component of their underlying debt and may have pursued related business and financing plans based on the transaction, it should not be assumed that default merely puts the parties in the position they were in before the swap. Such reliance on the swap may result in significant consequential losses in the event of default.⁴⁷ This risk can, however, be lessened through various credit enhancement techniques.⁴⁸

45. See *supra* note 22 and accompanying text.

46. See Kopprasch, *supra* note 5, at 15-16.

47. Such losses result from changes in balance sheet management made in reliance on the swap. Damages, however, would usually be quite speculative and therefore difficult to prove.

48. See *infra* notes 51-54 and accompanying text.

The next most critical risk is a change in the interest rate market. Each party to an interest rate swap is taking a position on the probable movement of variable interest rates. Movement in one direction or the other can eliminate the advantages of the swap. Changes in interest rates can have secondary effects on a swap party as well. For example, if a swap party enters into the transaction to match fixed-rate assets such as mortgages, and there is a sharp decline in long-term interest rates, the mortgages could be refinanced and rapidly eliminated as assets for which the swap was created. To use another example, a savings and loan institution could enter into a swap to match floating-rate liabilities, such as money market accounts, with its floating-rate mortgage loans. A sudden rise in interest rates or the introduction of a new savings product could shift savings to fixed-rate accounts, causing a mismatching of the liabilities and the interest rate swap.⁴⁹

A third risk to the swap party is the inability, either as a result of market conditions or poor business acumen, to negotiate a large enough spread over the variable rate, usually expressed as a number of basis points, that is to be paid to the fixed-rate payor as an inducement to enter into a swap with the less creditworthy variable rate payor.

A final risk is that of mismatch. A mismatch can occur with the use of one variable-rate index as the basis of the swap, while the underlying debt is geared to a different index. Such a mismatch is increasingly unlikely to occur because of the great differences between the rates and volatility among the various available indexes. Thus, only the most unsophisticated party would ever enter into a swap with such a mismatch present. Another mismatch can occur when the swap and the underlying debt are geared to the same index, but either the reset frequency⁵⁰ for the two indexes is different, or one index is geared to a 365/366-day year, while the other is geared to a 360-day year.

E. Credit Enhancement in Swap Transaction

In most swap transactions the variable-rate interest payment obligor will be an institution that is less creditworthy than the fixed-rate payment obligor.⁵¹ Furthermore, in many interest rate swap

49. This risk could, of course, be minimized by undoing or reversing the swap with a mirror swap. See *supra* note 45 and accompanying text.

50. The reset frequency is the period between rate changes.

51. See *supra* note 16 and accompanying text.

transactions, the swap payments are netted to produce a net payor and payee in the transaction. Because the lower rated institution typically swaps variable-rate debt for a higher fixed, but certain, interest rate obligation, it often will be the net payor of funds. As a result, it is sometimes the case that the higher rated, fixed-rate borrower will require that the lower rated borrower provide some credit enhancement to reduce the risk of default. This credit enhancement may be provided by an intermediary broker bank in the form of a letter of credit issued by a third party financial institution.⁵² The letter of credit guarantees payment of the net amount throughout the term of the interest rate swap transaction or payment of the termination fee, if any, or both. Additionally, the higher rated institution may require that the other party to the swap deposit with it, or with an independent escrow agent, collateral of a type and with a value that is negotiated between the parties to ensure a source of payment in the event the lower rated obligor defaults in the swap transaction.⁵³

New ways are being devised to reduce the risk of default by a less creditworthy swap partner. One such method is a provision in the swap contract that allows a swap party to elect at any time to receive collateral from the other party equal in value to the increase or decrease in the market value of the swap.⁵⁴

F. New, Innovative Uses of Swap Transactions

Interest rate swaps are gaining the attention of more than just corporate treasurers interested in active liability management. Although mini-swaps today seldom relate to principal amounts of less than ten to fifteen million dollars, the speed with which a swap can be consummated and the simplicity of its documentation make

52. This usually takes the form of a letter of credit from a commercial bank with an investment grade rating of its debt. Letters of credit are usually either *standby* letters of credit, in which the credit bank agrees to pay the beneficiary only in the event of nonpayment by the primary obligor, or *direct payment* letters of credit, pursuant to which the credit bank actually makes each of the primary obligor's payments to the beneficiary.

53. Collateralization of a party's obligations under a swap is often impossible. Pledges of assets are frequently prohibited by negative pledge clauses in loan documents. Further, delivery of collateral could in some circumstances be a recoverable preferential transfer in bankruptcy. See 11 U.S.C. § 547 (1982).

54. The First Boston Securities Corporation has included in some forms of its swap agreement a clause that permits either swap party to call for collateral equal to the net change in the market value of the swap at any time. Palm, *The Code of Standard Wording, Assumptions, and Provisions for Swaps*, in Interest Rate and Currency Swaps Program, Practising Law Institute 200 (Dec. 6, 1985).

the swap an attractive financing vehicle for almost any size of borrower or debt. Two new uses of swaps are becoming popular.

1. *Real Estate Development Companies.*—Companies or developers that finance the acquisition of industrial and commercial real estate often do so with floating-rate debt because of the relatively high cost of fixed-rate financing.⁵⁵ Fixed lease obligations, which increase over time but at predetermined intervals and in stated or calculated amounts, make floating-rate debt extremely risky. The availability of the swap creates new financing alternatives. If floating-rate debt is incurred with the intention of immediately swapping it for a fixed rate below the level of fixed rates that are otherwise available, the real estate company can assure itself of a predictable spread between lease income and the cost of funds. The risk to the counterparty to the swap is somewhat less than it would be in the many cases in which it looks only to the creditworthiness of a corporate swap partner. Analysis of the underlying leases can provide fairly clear assurances of the real estate company's ability to service the fixed-rate interest assumed in the swap. Large homebuilders, on the other hand, can use the interest rate swap to reduce the cost of working capital by using their corporate credit, rather than their asset base, to secure their swap position.⁵⁶

2. *Tax Exempt Borrowers.*—The tax exempt financing market⁵⁷ is also discovering the advantages of interest rate swaps. These swaps are no different from any other except that interest on both underlying debts is exempt from federal income taxation.⁵⁸ The likelihood is higher in this swap market that variable-rate indexes will differ, unless swap parties come together before the underlying debt is incurred.⁵⁹ Consequently, the possibility of arbitrage profit or loss is heightened because interest received from the swap partner may not

55. See Sperantsas & Hellmers, *supra* note 40, at 65.

56. *Id.* at 67.

57. The tax exempt financing market is the market for tax exempt industrial development bonds issued by political subdivisions.

58. Theoretically, interest could be taxable on one underlying debt and tax exempt on the other. However, due to the great disparity in interest rates between tax exempt debts and taxable debts, as well as the floating rate indexes and formulas that are used, it is unlikely that a swap would take place between a taxable party and a tax exempt party.

59. The indexes will probably differ because borrowers of tax exempt industrial development bond proceeds use a wide variety of indexes and pricing mechanisms that are not uniform in the industry.

equal, or may exceed, the required interest payment on the underlying debt.⁶⁰

Increasing the value of tax exempt financing through the use of swaps can be illustrated with two examples. Corporation A has borrowed \$30 million through the use of tax exempt bonds for a pollution control facility. The bonds are variable-rate tender bonds⁶¹ currently bearing an adjustable rate of 5.1%. At this point Corporation A could convert the bonds to a fixed rate of 8%, but is reluctant to do so because of the currently favorable variable rate. Yet, if interest rates rise, the fixed rate available to Corporation A also will rise. Corporation A believes the variable rate will not be as favorable in the future. Corporation A could solve this dilemma through an interest rate swap by converting its \$30 million in bonds to a fixed rate of 8% and then swapping that rate for some period of years with another borrower that has variable-rate tender bonds outstanding. It has thereby taken advantage of current short-term variable rates *and* locked in the favorable long-term fixed rate.

A second example is a multifamily housing developer who builds an apartment project with the proceeds of tax exempt bonds indirectly insured by the Department of Housing and Urban Development. The bonds carry a favorable, tax exempt fixed interest rate of 9.2% over thirty years. Yet the developer may be able to swap this favorable rate for a floating rate of 6.2% on a swap partner's tax exempt bonds. This swap would make the project's profits higher during the life of the swap. Obviously, the developer must assess the risk, based on historical results, of the floating-rate index's ever exceeding 9.2%.⁶²

IV. TREATMENT OF INTEREST RATE SWAPS UNDER FEDERAL TAX LAWS

A. Characterizing the Swap Payment

An interest rate swap raises tax issues for which the Internal Revenue Code (Code) provides no answer.⁶³ The most perplexing

60. In this example, arbitrage is the profit earned through the difference between the interest rate one pays and the interest rate one earns.

61. Tender bonds are bonds that can be "put" back to the issuer and remarketed at current short-term rates.

62. There has been a substantial disparity between commercial interest rates and highly rated, tax exempt "demand" bonds or notes. For example, when the prime rate in the U.S. exceeded 20.5%, triple A, seven-day tax exempt securities were priced at less than 9.5%.

63. The only certainty in this area is that of the tax law's uncertainty. See, e.g., Speech

tax issue in swap transactions is categorizing the periodic payments between the swap partners. The tax consequences of a swap payment depend upon its categorization, but current tax law provides no category into which a swap payment properly fits.⁶⁴ However, an appropriate tax treatment can be found within the boundaries of the current Code, and changes to the Code could be enacted for the purpose of dealing with this new financing technique. Examining the two component parts of an interest rate swap is helpful in analyzing the tax consequences of such a transaction.

The first component of a swap—the payment of interest by each party on its underlying debt to its original lender⁶⁵—should be taxed as though there were no swap in place. A swap is structured so that each party remains liable on the original loan obligations that form the basis of the swap transaction. Thus, each party continues to pay its own interest obligation on the underlying debt, which clearly is deductible as interest under section 163(a) of the Code.⁶⁶

by Robert H. Dilworth, U.S. Tax Implications of Swap Transactions, Glazier's Hall, London (Nov. 1, 1984), *available from* Tax Notes Today, Doc. No. 85-3040 [hereinafter cited as Dilworth] ("The problem with talking about swaps is that no section of the Internal Revenue Code deals explicitly with 'swaps.' . . . We are left with establishing reasonable, or at least defensible, positions for U.S. taxpayers to take when they . . . enter into an interest rate swap. . . ."). The trade literature has occasionally alluded to tax consequences of swaps, *see supra* note 5, but without providing clear guidelines as to proper tax treatment of this new technique.

64. This article considers the tax consequences only of a swap between two U.S. parties. If a foreign bank or corporation is a party to a swap, a multitude of international tax issues arise. For example, a swap with a foreign party may well impose a withholding tax on the U.S. party under I.R.C. § 1441 (1982) (withholding tax on nonresident aliens) and § 1442 (withholding tax on foreign corporations). The issue turns on whether the swap payment is characterized as interest or "other fixed or determinable, annual or periodical" income (§ 1441(b)) and whether it is of a U.S. or non-U.S. source (§ 1441(c)). If the transaction is a cross-currency interest rate swap, additional issues arise as to the characterization of the gain or loss on the currency exchange. *See* Henrey, *supra* note 5, at 31-17 to 31-22. Moreover, payments made to a U.S. party may cause the U.S. party to be taxed both here and in the foreign jurisdiction because a U.S. taxpayer's credit for foreign taxes paid is limited by the foreign tax credit limitation. I.R.C. §§ 903-04. The amount allowable as a credit raises the issues of whether the swap payment is interest and whether it is of a U.S. or foreign source. *Id.* These tax issues are beyond the scope of this article. For a discussion of the tax consequences of international swaps, *see* Henrey, *supra* note 5, at 31-2 to 31-26; Dilworth, *supra* note 63, at 1-25.

65. Of course, the swap does not affect the position of the original lender; therefore, the swap has no tax consequences whatsoever with respect to the lender.

66. I.R.C. § 163(a) provides, "There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness." As a result, the party that swaps fixed- for variable-rate interest, whose actual cost of borrowing is at a variable rate, will nonetheless deduct interest at the fixed rate of the original loan. Likewise, the party that swaps variable- for fixed-rate interest will deduct interest at the variable rate.

The periodic payments between the swap partners that comprise the second component of an interest rate swap do not fit so neatly into any of the categories of the Code. With respect to the payor, it is not clear whether the swap payment should be viewed as a current expense item or as a capital expenditure. With respect to the payee, it is uncertain whether the payment should be recognized as ordinary income or as the amount realized from the sale or exchange of a capital asset.

In economic terms, one party to a swap will always realize a net gain, while the other will always realize a net loss. That is, the respective swap payments will rarely, if ever, be of equal value. Thus, one party will pay out a greater swap payment than it will receive (the difference representing a loss), while the counterparty will receive a greater payment than it will pay out (the difference representing a gain). For tax purposes, it is not clear whether each party should net out its received and paid-out swap amounts and simply realize a gain or loss, or whether the two payments should be treated as separate transactions.⁶⁷ If the payments are netted out, the parties must determine when the gain or loss should be recognized and whether it should be ordinary or capital.⁶⁸

67. In practice, the parties often net the reciprocal payments. See *supra* note 6 and accompanying text. In that case, one party makes a payment and receives nothing, while the other party receives a payment and pays nothing. As such, the net payment represents the actual gain or loss to the parties from the transaction. Even if the payments are made at different times, but one is greater than the other, we refer to the party making the larger payment as the "net payor" and the other as the "net payee." To the net payor, the net payment represents a loss because the party is making that much more of a cash outlay than it would have made without a swap in place. To the net payee, it represents a gain because the party is that much better off in terms of real dollars than it would have been without a swap in place.

For tax purposes, it should make no difference whether the payments are netted. Proper tax policy is neutral with regard to the form of a transaction; substance should always govern over form. See, e.g., *Kimbell Diamond Milling Co. v. Commissioner*, 14 T.C. 74 (1950), *aff'd*, 187 F.2d 718 (5th Cir. 1951) (per curiam), *cert. denied*, 342 U.S. 827 (1951) (recognizing that individual steps of a stock purchase and liquidation (form) may in some circumstances be disregarded and treated as one unified transaction (substance)).

68. A capital asset is defined as property held by the taxpayer other than inventory, property used in the taxpayer's trade or business, copyrights, literary, musical, or artistic compositions, letters or memoranda, accounts receivable, or publications of the United States Government. I.R.C. § 1221. The gain or loss recognized from the sale of a capital asset is given special treatment under the Code. In general, only 40% of the net gains from capital assets held by the taxpayer for more than six months (net long-term capital gains) are includible in the taxpayer's income. I.R.C. § 1202(a). Net losses from capital assets held by individuals for more than six months (net long-term capital losses) are generally deductible only to the extent of 50% of the loss. I.R.C. § 1211(b). Gains or losses from capital assets held for less than six months (short-term capital gains or

1. *Characterization of Payment.*—The analysis begins with an attempt to characterize the periodic payments. At first blush it might appear that a swap payment should be characterized as interest because of its relationship to the underlying debt. That is, the amount of a swap payment is geared to the amount of interest each party is obligated to pay with respect to an underlying debt. It is clear on reflection, however, that characterization of the payment as interest is entirely inappropriate. The payment is not interest because, as between the swap partners, there is no underlying debt.⁶⁹ An interest rate swap involves no exchange of principal; it is merely a promise to pay a stream of income based upon the interest owed on the other's debt. The underlying debt serves only to calculate the amount of the swap payment.⁷⁰

Another reason why a swap payment should not be classified or deducted as interest is that the payment represents the interest obligation of another. Interest is deductible as such only if the underlying debt is owed by the taxpayer rather than by someone else.⁷¹ Moreover, if interest rate swap payments were deductible as interest, there would be a double deduction. The first deduction would be taken by the party that actually pays the interest on its underlying debt; the second, by the party that makes the swap payment. Thus, a swap payment should not be deducted as interest.

2. *Non-Interest Cost of Financing.*—A swap payment may also be characterized as a non-interest cost associated with financing the underlying debt. An analogy might be drawn between a swap payment and a commitment fee or broker's fee. These fees represent an amount paid in connection with the negotiation of a loan.⁷²

losses) are treated the same as ordinary income or losses, respectively. *Id.*; see also *infra* note 98 (purpose of special treatment of capital gains and losses).

69. Interest has been defined as the amount that one contracts to pay for the use of borrowed money, *Old Colony R.R. v. Commissioner*, 284 U.S. 552, 560 (1932), and as "compensation for the use or forbearance of money," *Deputy v. DuPont*, 308 U.S. 488, 498 (1940). To be deductible under I.R.C. § 163(a) there must exist a bona fide indebtedness. See, e.g., *Autenreith v. Commissioner*, 115 F.2d 856 (3d Cir. 1940) (taxpayer was denied an interest deduction when the obligation was to pay only interest and not to repay principal). For a general discussion of the interest deduction, see Asimow, *The Interest Deduction*, 24 UCLA L. Rev. 749 (1977).

70. See Dilworth, *supra* note 63, at 4; cf. Henrey, *supra* note 5, at 31-11 (discussing cross-currency swaps).

71. *Colston v. Burnet*, 59 F.2d 867, 870 (D.C. Cir.), cert. denied, 287 U.S. 640 (1932).

72. A commitment fee is paid by a borrower to a bank for the purpose of having money made available when needed and for preserving an interest rate. If a loan commitment is exercised, the commitment fee is deemed a cost of acquiring the loan and is to be deducted ratably over the term of the loan. See Rev. Rul. 81-160, 1981-1 C.B. 312-

A swap payment, however, should not be deducted as a commitment fee or broker's fee because, in reality, it has no economic or factual relationship to the underlying debt. An interest rate swap is frequently negotiated and transacted without the knowledge of the underlying lender. It has no bearing on the party's ability to contract the underlying debt. Indeed, it is not unusual for an interest rate swap to take place years after the underlying debt has been incurred. It therefore makes no sense to tax the swap payment as if it were an additional cost of the underlying debt.

3. *Ordinary Business Expenditures.*—The prevailing view of the financial community, as suggested by the trade literature, is that a swap payment is a business expense deductible under I.R.C. section 162 as a current expense item.⁷³ The literature likewise suggests that amounts received by the net payee in a swap are reported as ordinary income.⁷⁴

For an item to be deductible under I.R.C. section 162, the cost must be an ordinary and necessary expense of the business⁷⁵—"necessary" means appropriate and helpful for the development of the taxpayer's business;⁷⁶ "ordinary" distinguishes between current expenses and capital expenditures.⁷⁷ When permitted, a capital expenditure must be amortized over the useful life of the asset rather

13. The ruling also provides that "[i]f the right [to a loan] is not exercised, the taxpayer may be entitled to a loss deduction under [I.R.C. § 165] when the right expires." *Id.* at 313.

73. I.R.C. § 162(a) provides that "there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. . . ." See, e.g., CURRENCY AND LIABILITY SWAP GROUP, MERRILL LYNCH CAPITAL MARKETS, MEMORANDUM ON INTEREST RATE SWAPS, at 7 ("Periodic payments under a swap constitute interest income and interest expense, and can be netted in determining interest expense. . . . Periodic payments under a swap are considered to be ordinary. Payments made are expensed [i.e., currently deductible] and payments received are a decrease in deductible expense [i.e., ordinary income].").

74. See *supra* note 73.

75. *Commissioner v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345, 352 (1971).

76. *Commissioner v. Tellier*, 383 U.S. 687, 689 (1966).

77. *Welch v. Helvering*, 290 U.S. 111, 113-16 (1933). The fine distinction between those costs which are "ordinary" and those which are "capital expenditures" continues to elude most courts. Early cases applied a "one year rule" and identified any expense as a capital expenditure if its benefit to the business lasted longer than the business' taxable year. See *Fourth Circuit Review*, 40 WASH. & LEE L. REV. 459, 842 (1983) (citing *Commissioner v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345, 354 (1971); *Colorado Springs Nat'l Bank v. United States*, 505 F.2d 1185, 1191-92 (10th Cir. 1974); *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 782-87 (2d Cir. 1973)). More recently, courts have applied a "separate and distinct additional asset" test. *Id.* See also *NCNB Corp. v. United States*, 684 F.2d 285 (4th Cir. 1982) (en banc) (the presence of a benefit for more than one year should no longer be the controlling factor).

than currently deducted.⁷⁸

The problem with blanket treatment of a swap payment as an I.R.C. section 162 expense item is that it ignores the possibility that—at least for some taxpayers—a swap transaction is more similar to acquiring a capital asset than to incurring an ordinary business expense. Although the interest rate swap takes an unusual form, it is in substance identical to the conventional investment security.⁷⁹ The swap is entered into with a profit motive or to hedge a debt position, and the transaction involves definite risks.

4. *Commodity and Interest Rate Futures.*—While the Code does not address interest rate swaps per se, it does address two types of transactions that are similar to the interest rate swap—commodity futures and interest rate futures. A commodity futures contract is an agreement to purchase or sell a specified quantity of a specified commodity at a specified price at or before some time in the future.⁸⁰ An interest rate future is an agreement to buy or sell a financial instrument, such as a Treasury bill, Eurodollar deposit, or certificate of deposit, at a given rate of interest at a future time.⁸¹ Like interest rate swaps, interest rate futures may hedge against the parties' interest rate risk, i.e., by offsetting or reducing the risk that interest rates might fluctuate unfavorably. Alternatively, futures contracts, like interest rate swaps, may be capital investments for investors who purchase the futures contracts with an intent to profit from the transaction.⁸²

78. *Commissioner v. Tellier*, 383 U.S. at 689-90. See I.R.C. § 263.

79. "Security" is defined in I.R.C. § 1236(c), for purposes of determining whether a taxpayer is a dealer in securities, as "any share of stock in any corporation, certificate of stock or interest in any corporation, note, bond, debenture, or evidence of indebtedness, or any evidence of an interest in or right to subscribe to or purchase any of the foregoing." "Evidence of indebtedness" is broad enough to encompass a swap agreement that entails a duty to make periodic payments and a right to receive the same.

80. See *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46, 47 n.1 (1955) (citing *HOFFMAN, FUTURE TRADING* 118 (1932)); *How to Buy and Sell Commodities* (Merrill Lynch, Rev. Ed.) at 6.

81. IRS Letter Ruling 8440025 (Jun. 29, 1984).

82. In *United States v. New York Coffee & Sugar Exch.*, 263 U.S. 611, 619 (1924), the Supreme Court observed:

Those who deal in "futures" are divided into three classes: first, those who use them to hedge, i.e., to insure themselves against loss by unfavorable changes in price at the time of actual delivery of what they have to sell or buy in their business; second, legitimate capitalists, who, exercising their judgment as to the conditions, purchase or sell for future delivery with a view to profit based on the law of supply and demand; and, third, gamblers or irresponsible speculators, who buy or sell as upon the turn of a card.

The third category is beyond the scope of this article.

Futures contracts are generally deemed to be capital assets,⁸³ the sale or exchange of which gives rise to capital gain or loss treatment.⁸⁴ However, the transaction is given ordinary income treatment whenever the futures contract is entered into in connection with the taxpayer's day-to-day business activity as a hedge against price fluctuations in ordinary income producing assets.⁸⁵

83. An exception to the general treatment is the regulated futures contract which, since the enactment of the Economic Recovery Tax Act of 1981 (ERTA), has been afforded a unique form of taxation. A "regulated futures contract" is defined in I.R.C. § 1256(g)(1) as "a contract—with respect to which the amount required to be deposited and the amount which may be withdrawn depends on a system of marking to market, and which is traded on or subject to the rules of a qualified board or exchange." While virtually all futures contracts pertaining to commodities are entered into and terminated through exchanges, other futures contracts such as foreign futures are entered into directly between the parties. The latter do not fall within the definition of regulated futures contracts, and thus, the common law rules of futures contracts should still apply to them, notwithstanding § 1256.

Prior to the enactment of ERTA (Pub. L. No. 97-34, 95 Stat. 172 (1981)), a number of uncertainties under the tax laws regarding futures transactions allowed those transactions to be used as a mechanism for a variety of abusive tax shelters that had no economic substance. In 1981, as part of ERTA, I.R.C. § 1256 was enacted. The purpose of this section was to limit the use of tax shelter schemes involving futures contracts by taxing them in a manner intended to reflect cash flows associated with the marked-to-the-market accounting systems employed by domestic commodity exchanges.

Under the general rule of § 1256 of the Code, a regulated futures contract held by the taxpayer at the close of the taxable year is treated as if sold at fair market value on the last business day of the taxable year. Forty percent of any gain or loss is taxed as short-term capital gain or loss and the remaining sixty percent is taxed as long-term capital gain or loss. See *supra* note 68.

Section 1256(e) of the Code contains a significant exception for hedging transactions. A hedging transaction is defined as a transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily to reduce the risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or obligations incurred or to be incurred by the taxpayer. Gain or loss on these transactions is treated as ordinary if the taxpayer clearly identifies the transaction as being a hedge transaction. For a discussion of the new treatment, see generally Rudnick, Carlisle, & Dailey, *Federal Income Tax Treatment of Commodities Transactions*, 24 B.C.L. REV. 301, 309-16 (1983).

84. See *L.M. Muldrow v. Commissioner*, 38 T.C. 907 (1962); see also *Modesto Dry Yard v. Commissioner*, 14 T.C. 374(A) (1950) (commodity futures are capital assets except when used as a legitimate hedge); see generally *supra* note 68 (definition of capital asset and consequences of capital treatment).

85. *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46, *reh'g denied*, 350 U.S. 943 (1955). *Corn Products* represents the judicial creation of an important exception to the definition of a capital asset. The Supreme Court ruled that a commodity futures contract entered into by a taxpayer in connection with his day-to-day recurring business activity was not a capital asset because the taxpayer's primary motive for purchasing the contract was to achieve price protection of inventory. *Corn Products* has come to stand for the proposition that a transaction will be given ordinary, rather than capital, treatment if the transaction is entered into as an integral part of the taxpayer's day-to-day business or if it is necessary to protect or generate ordinary operating income.

An interest rate swap, like a futures contract, should in many cases be deemed a capital asset because an interest rate swap is a contractual right to take possession of something (i.e., a stream of income) in the future.⁸⁶ Because "capital asset," as defined in I.R.C. section 1221, is broad enough to include the kind of intangible property right that an interest rate swap represents,⁸⁷ an interest rate swap should be deemed a capital asset in all cases unless the particular facts require a different conclusion. An exception to the general rule would arise whenever an interest rate swap is transacted as a hedge against fluctuations in interest rates. In such cases, the interest rate swap would be exempt from capital asset treatment by virtue of the *Corn Products* doctrine.⁸⁸

B. Taxation of Interest Rate Swap As a Capital Asset

The amount paid for the acquisition of a capital asset is not currently deductible as an ordinary and necessary business expense under I.R.C. section 162(a).⁸⁹ If it has an ascertainable life, its cost may sometimes be amortized over the life of the asset.⁹⁰ Upon its sale or exchange, it gives rise to capital gain or capital loss.⁹¹ Treating an interest rate swap as a capital asset, however, is problematic because the Code's scheme for taxing a capital asset is inadequate to deal with interest rate swaps: the swap's unique mechanics make it difficult to view the interest rate swap in terms of basic tax precepts such as "basis"⁹² and "amount realized."⁹³

86. See *Commissioner v. Covington*, 120 F.2d 768, 771 (5th Cir. 1941) (Holmes, J., concurring) ("Transactions in commodity futures are commonly spoken of as purchases and sales of a specific commodity such as corn, wheat, or cotton, but the traders really acquire rights to the specific commodity rather than the commodity itself. These rights are intangible property which may appreciate or depreciate in value.").

87. I.R.C. § 1221 provides that "property held by a taxpayer" is a capital asset *unless* an exception applies. See *supra* note 68. Because the Code uses this negative definition of capital asset, the general rule is that an asset is a capital asset. Although many would argue that the exceptions far outnumber the rule, the analysis necessarily begins with this as the general rule.

88. See *supra* note 85.

89. Cf. *Commissioner v. Lincoln Sav. & Loan Ass'n*, 403 U.S. 345, 354 (adopting "separate and distinct asset test" as means of distinguishing capital from ordinary expenditures).

90. See I.R.C. §§ 167, 168.

91. See *supra* note 68.

92. "Basis" is generally defined as the cost of property. I.R.C. § 1012. Basis is significant because it is the amount by which the gain or loss on the disposition of a capital asset is measured (I.R.C. § 1001(a)), and because it is the amount that a taxpayer may depreciate over a capital asset's lifetime (I.R.C. § 167).

93. "Amount realized" is the sum of money on property received upon the sale or disposition of property. I.R.C. § 1001(b).

One way to view the swap transaction is as if the outgoing swap payments represent the purchase price of the acquired asset—a price which is paid in installments over the life of the swap. The payments do indeed represent the cost of entering into the swap. As the cost of acquiring a capital asset, they should not be currently deductible. Instead, their aggregate should be deemed the swap's basis, deductible over the life of the swap or recoverable against any gain made from the swap upon its sale or termination. The purchase price should not be subject to a capitalization requirement because the periodic payments are spread out evenly over the life of the agreement: in a sense, they are naturally capitalized.

The incoming swap payments represent what the party receives from its investment. The amount received, up to the "purchase price," is a return of capital and should not be taxed. Any amount received in excess of the purchase price is clearly profit and must be recognized as capital gain (when capital treatment is appropriate).⁹⁴ In the event the party receives less than the purchase price, it should be entitled to recognize either an ordinary or capital loss for the difference.

For the party to recognize a long-term capital gain or loss, the Code requires the sale or exchange of a capital asset that has been held by the taxpayer for the statutory holding period—currently six months.⁹⁵ However, when a swap terminates according to the contract terms, current law does not recognize a "sale" or "exchange." The Code, therefore, should be amended to provide that a deemed sale or exchange occurs upon the swap agreement's termination, by its own terms or prematurely, so that any gain or loss will be given capital treatment if the holding period requirement is met.⁹⁶ Capital gain or loss treatment makes sense because it is consistent with

94. See *supra* note 68.

95. The six-month holding period is set forth in I.R.C. § 1222(e). See *supra* note 68.

96. The Code already contains such a provision in the case of regulated futures contracts and other forms of securities. I.R.C. § 1234A provides:

Gain or loss attributable to the cancellation, lapse, expiration, or other termination of—

(1) a right or obligation with respect to personal property [or a regulated futures contract] which is . . . a capital asset in the hands of a taxpayer. . . shall be treated as gain or loss from the *sale* of a capital asset.

"Personal property" is defined in I.R.C. § 1092(d)(1) as "any personal property of a type which is actively traded." Although an interest rate swap could arguably fall within the definition of personal property, it would probably not meet the "actively traded" requirement.

the policy of special tax treatment for those gains or losses that occur over a long period of time.⁹⁷

Moreover, for the Code to provide otherwise would invite the creation of abusive tax schemes with regard to swaps. Just as with regulated futures contracts, there are primarily two ways for a taxpayer to undo a swap—the swap can terminate naturally by its own terms, or the swap can be “sold” in the secondary market.⁹⁸ As a capital asset, the sale of the swap in the secondary market should always give rise to capital gain or loss. If the termination of a swap agreement were treated any differently from a sale in the secondary market, the taxpayer could manipulate the form of the “undoing” to obtain the most advantageous treatment. A taxpayer expecting to recognize a gain would always sell the swap in the secondary market before its termination to induce recognition of a capital gain, whereas a taxpayer expecting to recognize a loss would always terminate the swap to permit recognition of an ordinary loss. The Code should be amended to provide the same tax treatment in either case so that the method chosen by the taxpayer to undo a swap would be tax neutral.⁹⁹ Amending the Code would prevent an inefficient distortion of the market.

C. Taxation of an Interest Rate Swap as a Hedge

When an interest rate swap is entered into as a hedge against changes in interest rates, the expense is similar to that of buying insurance or additional inventory: it should not be given capital treatment.¹⁰⁰ The outgoing swap payment should be currently deducted under I.R.C. section 162(a).

The payments received from the swap should be ordinary income under I.R.C. section 61, which taxes all income received from whatever source derived. The payments should be reported in the

97. See *Burnet v. Harmel*, 287 U.S. 103, 106 (1932) (“Before the Act of 1921, gains realized from the sale of property were taxed at the same rates as other income, with the result that capital gains, often accruing over long periods of time, were taxed in the year of realization at the high rates resulting from their inclusion in the higher surtax brackets. The provisions of the 1921 revenue act for taxing capital gains at a lower rate, reenacted in 1924 without material change, were adopted to relieve the taxpayer from these excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.”) (citing H.R. REP. NO. 350, 67th Cong., 1st Sess. 10 (1921)).

98. See *supra* note 44, and accompanying text.

99. This is precisely the reasoning that prompted Congress to enact I.R.C. § 1234A with respect to regulated futures contracts. See Rudnick, Carlisle & Dailey, *supra* note 83, at 316, 338.

100. See *Corn Products*, 350 U.S. 46.

taxable year in which they are received. The income from payments should be offset by the deduction for outgoing payments so that the net effect will be ordinary income or loss to the taxpayer.

*D. Distinguishing Between Hedging Transactions
and Capital Transactions*

Whether a swap is a hedge or a capital transaction is a question of fact that should turn on the taxpayer's motive for participating in the transaction. The finder of fact will have to determine, from all of the attendant circumstances surrounding any given transaction, whether the swap was transacted for investment or hedging purposes. As is always the case in applying the *Corn Products* doctrine, the most troublesome issues will arise when a taxpayer becomes a party to a swap for *both* hedging and investment purposes.

The position taken by both the IRS¹⁰¹ and the Tax Court¹⁰² is that a transaction entered into with a substantial investment purpose receives capital treatment, even if there is a more substantial hedging motive for the transaction. The Court of Claims has taken a contrary position, holding that stock is a capital asset if held *predominantly* for investment purposes, and otherwise is not a capital asset, even if held *substantially* for a hedging purpose.¹⁰³

A hedge has been described as a form of price insurance, contracted to avoid the risk of fluctuations in the market price of a commodity.¹⁰⁴ The courts might also rely on the definition of "hedging" transactions in I.R.C. section 1256(e)(2). "Hedging" is

(A) any transaction if such transaction is entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily (i) to reduce risk of price change or currency fluctuations with respect to property which is held or to be held by the taxpayer, or (ii) to reduce risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or obligations incurred, or to be incurred, by the taxpayer¹⁰⁵

101. See Rev. Rul. 78-94, 1978-1 C.B. 58 (revoking Rev. Rul. 75-13, 1975-1 C.B. 67).

102. *W.W. Windle Co. v. Commissioner*, 65 T.C. 694 (1976), *appeal dismissed*, 550 F.2d 43 (1st Cir. 1977), *cert. denied*, 431 U.S. 966 (1977).

103. *Union Pac. R.R. v. United States*, 524 F.2d 1343 (Ct. Cl. 1975), *cert. denied*, 429 U.S. 827 (1976).

104. 3B MERTENS LAW OF FEDERAL INCOME TAXATION § 22.14 (1980) (citing *Commissioner v. Farmers & Ginners Cotton Oil Co.*, 120 F.2d 772 (5th Cir. 1941); *Main Line Distrib., Inc. v. Commissioner*, 37 T.C. 1090 (1962), *aff'd*, 321 F.2d 562 (6th Cir. 1963); Rev. Rul. 60-24, 1960-1 C.B. 171).

105. I.R.C. § 1256(e)(2).

However, it has been suggested that "the scope of the hedging transaction doctrine enunciated by the Supreme Court in *Corn Products Refining Co. v. United States* could go well beyond the scope of the statutory definition of hedging transactions found in I.R.C. § 1256."¹⁰⁶ Thus, even if the statutory definition is deemed too narrow to encompass the interest rate swap, it might still fall within the broader definition of "hedge" under the *Corn Products* doctrine.

E. Timing of Recognition

In the case of swaps that are given capital treatment, a primary issue is *when* the capital gain or loss should be recognized. One alternative would be to defer recognizing either gain or loss until the termination of the swap. The taxpayer would have no tax consequences until the swap expires, is sold, or is earlier terminated. The other alternative would be to require the taxpayer to recognize gain or loss with respect to those payments paid or received within any given tax year.

The Code's "closed transaction doctrine,"¹⁰⁷ which provides that a transaction has no tax consequences until it is completed and closed, seems to dictate the former treatment. This doctrine holds that one cannot know the actual purchase price of a transaction involving contingent payments until the transaction is closed. In the case of a swap, assuming that either the incoming or outgoing swap payment is based upon a variable rate of interest, the entire purchase price or the entire amount to be received from the transaction is unknown until the swap transaction terminates. Thus, a party should not recognize a capital gain or loss until the swap's termination.

F. Special Situations

Some special rules might apply if a bank or savings and loan association is a party to an interest rate swap transaction. Banks and trust companies in general are taxed in the same manner as other corporations. However, by virtue of I.R.C. section 582(c)(1), the sale or exchange of a bond, debenture, note, certificate, or other

106. Rudnick, Carlisle & Dailey, *supra* note 83, at 301, 328.

107. The closed transaction doctrine appears in several contexts throughout American tax law. For example, Treas. Reg. 1.165-1(b) (1954) provides that in order to deduct a loss under I.R.C. § 165, "a loss must be evidenced by closed and completed transactions, fixed by identifiable events." In *Burnet v. Logan*, 283 U.S. 404 (1931), the Supreme Court held that a taxpayer need not recognize gain or loss on the sale of property until the amount to be realized from the sale could be ascertained.

evidence of indebtedness by a bank is not considered the sale or exchange of a capital asset.¹⁰⁸ This statute should *not* be applied to interest rate swaps, inasmuch as the asset that is sold or exchanged as part of an interest rate swap is not a bond, debenture, note, or certificate of indebtedness. Thus, banks should be able to avail themselves of capital treatment when appropriate. Nevertheless, due to the hedging motive of banks in most swap transactions, application of the *Corn Products* doctrine would normally result in ordinary treatment. Finally, brokers' commissions or other fees paid with regard to a swap should be treated the same as with regard to any other kind of financial transaction: they should be deducted ratably over the life of the swap.¹⁰⁹

G. Summary

The tax treatment of an interest rate swap should depend upon the taxpayer's motive for entering into the swap. If it is entered into as an investment, capital treatment should follow. If it is entered into in the ordinary course of business as a hedge against changing interest rates, it should be given ordinary treatment.

V. INTEREST RATE SWAPS AS "SECURITIES" UNDER THE FEDERAL SECURITIES LAWS

A. *Is an Interest Rate Swap a Security?*

The definition of the term "security" in the Securities Act of 1933¹¹⁰ (1933 Act) is broad enough to encompass almost any

108. I.R.C. § 582(c)(1).

109. Another section of the Code that could potentially apply to interest rate swaps is § 1092, added by the ERTA, which disallows losses from the sale of the short position of a straddle (the simultaneous purchase is immediately replaced by another short position). Section 1092 was added to the Code to cover tax motivated straddle sales not covered by the wash sale rules in § 1091 or similar rules in § 1256 that relate exclusively to regulated futures contracts. For the straddle rules of § 1092 to apply, the personal property subject to the straddle must be "actively traded." Consequently, as the secondary swap market continues to grow, the possibility of applying § 1092 to swap market transactions will increase because swaps will be deemed to constitute personal property that is actively traded.

110. Securities Act of 1933, 15 U.S.C. §§ 77a-77bb (1982) (1933 Act). Section 2(1) of the 1933 Act defines "security" as

any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or

financing device used to raise capital, speculate, or hedge an economic position, yet narrow enough to exclude certain "stock."¹¹¹ Thus, courts have held that stock in a cooperative housing project was not "stock" for purposes of the 1933 Act,¹¹² but that a sales program for products not within the technical reach of any of the terms used to define the term "security" was nevertheless a "security" for purposes of the Act.¹¹³ It is clear that the courts have come to place primary emphasis on the question: Is this the type of economic arrangement intended to be covered by the Act? The 1933 Act is designed to protect "investors." If the courts can find an aggrieved investor, the technical or prolix niceties of definitional linedrawing will yield to the broad purposes of the 1933 Act.¹¹⁴ Conversely, if one purchases a cooperative apartment in an arrangement that technically involves the issuance of a stock certificate, but does not reflect any of the typical characteristics of stock, the courts quite rightly ignore the technical definition of "security" as including "any . . . stock" and find nothing more than the purchase of real estate, a commercial transaction obviously not intended to fall within the 1933 Act's broad reach.¹¹⁵

Whether a financing transaction is a security is a weighty issue for the participants. If the 1933 Act covers the arrangement, two

index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

111. See generally 3 H. BLOOMENTHAL, *SECURITIES AND FEDERAL CORPORATE LAW* § 2.02 (1979) (discussing definition of "security").

112. *United Hous. Found. v. Forman*, 421 U.S. 837 (1975).

113. *S.E.C. v. Glenn W. Turner Enters., Inc.*, 474 F.2d 476 (9th Cir.), *cert. denied*, 414 U.S. 821 (1973) (interpreting and expanding the classic definition of "investment contract" in *S.E.C. v. W. J. Howey Co.*, 328 U.S. 293 (1946)).

The authors do not believe it is necessary to put interest rate swaps through the rigors of classic "investment contract" analysis because a security can be found in such arrangements without doing so. "Investment contract" is only one of a dozen arrangements which § 2(1) of the 1933 Act declares to be securities. The courts have preferred to use the investment contract analysis to categorize investment vehicles for two reasons. First, there is a significant body of case law dealing with the meaning of the term. Second, "investment contract" is intrinsically vague, thereby lending itself to judicial definition, whereas the other terms in § 2(1) are far more precise. We believe that the courts too often resort to investment contract analysis when they could find, more simply, an "interest . . . in . . . a profit-sharing agreement" or an "interest . . . commonly known as a security," to cite only two examples of the arrangements listed in § 2(1).

114. See H. BLOOMENTHAL, *supra* note 111, § 2.19B.

115. See *supra* note 113.

consequences result. One, the arrangement must be registered with the Securities and Exchange Commission,¹¹⁶ unless an exemption applies. Two, with or without a registration exemption, the antifraud provisions of the 1933 Act and the Securities Exchange Act of 1934 (1934 Act) will apply.¹¹⁷

The interest rate swap should be viewed using this analytical method. The scope of the two Acts is not limited to particular characteristics of the investor—they apply equally to financial institutions and corporations and to individuals. Consequently, analysis must focus on the transaction itself. In particular, the issue is whether an interest rate swap is the kind of financing arrangement that the 1933 and 1934 Acts were designed to regulate. On this premise, it follows that interest rate swap contracts are securities; that such contracts seldom, if ever, would require registration because of the nature of both the participants and the transactions; and that the antifraud provisions of the 1933 and 1934 Acts do and should apply to interest rate swaps.

There is no doubt that the debt transactions underlying an interest rate swap are not within the Acts' reach because they are commercial borrowing transactions.¹¹⁸ In the swap, however, the gross

116. The Securities and Exchange Commission (SEC) is the administrative agency which regulates at the federal level, securities markets, brokers and dealers, sales of securities, investment advisors, trust indenture qualifications management companies and others. The SEC has broad investigatory and judicial powers in addition to its regulatory ones. See H. BLOOMENTHAL, *supra* note 111, § 1.01.

117. Securities Exchange Act of 1934, 15 U.S.C. § 78a-78kk (1982) (1934 Act). Rule 10b-5 (17 C.F.R. § 240.10b-5), promulgated under § 10 of the 1934 Act, states:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange:

- (a) To employ any device, scheme, or artifice to defraud,
- (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Rule 10b-5 may be the most widely discussed provision in all of the literature on federal securities laws. For an excellent treatise analysis of the case law that has developed from the Rule, see A. JACOBS, *LITIGATION AND PRACTICE UNDER RULE 10B-5* (Securities Law Series Vols. 5-5D 1985).

In addition to Rule 10b-5, express civil remedies are provided by the 1933 Act under § 12(1) (action by purchaser of unregistered securities); § 11 (action for false registration statement); § 12(2) (action for fraud in the sale of securities generally), and by the 1934 Act under § 18(a) (action for fraud in 1934 Act filings).

118. See § 3(a)(3) of the 1933 Act, 15 U.S.C. § 77c(a)(3) (1980). However, some of

or net payments are distinct from the underlying debt. The net payment to a third party represents the purchase price of the right to pay a fixed, although higher, rate of interest over a given period of time. The transaction also involves a speculation on the movement of interest rates, even though most swap participants do not consciously view the transaction in this way. Thus, the net payor of funds is in a position similar to that of the purchaser of an option on the Standard & Poor's 100,¹¹⁹ or the purchaser of an option on a Treasury bond or note.¹²⁰ These options transactions clearly involve the purchase of a security, inasmuch as they involve a payment designed to permit the net payor of funds to better its economic position, depending upon the movement of the stock market or long-term interest rates, respectively. An interest rate swap transaction also involves a payment designed to permit the net payor to better its economic position.¹²¹ The net payee in a swap transaction, because usually dealing with a lower rated borrower, assumes the financial risk that the net payor may default. In addition, the net payee is also speculating on the movement of interest rates and assuming the risk that rates will increase dramatically. These assumptions of risk demonstrate that the transaction is a security even when

these transactions are regulated by the Acts, such as the public issuance of bonds or notes.

119. The purchaser of an option on the S&P 100 index, an index of 100 representative stocks, is taking a position on the probable direction of movement in the "market." Such options, which are traded on the Chicago Board Options Exchange, do not really give the holder the right to purchase the 100 underlying securities, but rather are settled at expiration. For example, an investor purchases one option on the S&P 100 index with an exercise price of 185 and a September expiration for \$200 at a time when the index is at 183. The investor is speculating that the market will move upward sufficiently to cause the index to rise above 187 prior to expiration of the option in September. On the expiration date, the option will have a theoretical value of zero. Consequently, the index must be above 187 in order to cover the \$200 cost of the option. To the extent it is higher, exercise of the option results in a profit in that amount. Conversely, the seller of the same option is speculating that the index will remain at its present level or decline, in which case the seller need not net his position, and retains the \$200 premium as income.

120. Options and futures on interest rate instruments, such as Treasury bonds, are traded exactly as the S&P 100 options are. See *supra* note 119. However, the exercising holder and exercised seller of such an option must purchase and sell, respectively, the underlying financial instrument, as opposed to being required to buy-in or buy-out of the position prior to expiration of the option. Purchasers and sellers of options and futures on financial instruments engage in these transactions either to speculate on the movement of interest rates or to hedge positions in the underlying financial instruments.

121. This analogy is similar to the analogy to futures transactions. See *supra* notes 80-88 and accompanying text. The analogy applies to both types of transactions because the distinctions between options on securities and futures contracts are technical, not conceptual. See generally H. BLOOMENTHAL, *supra* note 111, § 2.21[a].

viewed from the standpoint of the net payee. The interest rate swap should be deemed a "security" for purposes of the 1933 Act.¹²²

B. Exemption from Registration Under the 1933 Act

Registration of an offering of securities under the 1933 Act entails significant expenditures of time by officers of the issuer, attorneys, and accountants, as well as significant legal and accounting fees and printing expenses. Generally, issuers go to great pains to avoid registration if it is possible to do so. In particular, issuers attempt to make their transactions fall within an exception to registration. Section 3¹²³ exempts certain securities and section 4¹²⁴ exempts certain transactions from the registration requirements imposed by the 1933 Act. Section 4(2)¹²⁵ exempts from registration "any transaction not involving a public offering." Nowhere in the Act is the term "public offering" defined or illustrated.¹²⁶ In interpreting this statutory prerequisite, the courts have chosen to define the term by arriving at various vague and sometimes contradictory definitions of what a public offering, or distribution, is not.¹²⁷ Thus,

122. This conclusion is not entirely free from competing analyses. The opposite conclusion would be based on the argument that there is no security being purchased and sold, but merely an exchange of obligations. Yet there is no true exchange of obligations by swap partners, whose contractual obligation to the creditor in the underlying debt transaction is not affected by the swap. The strongest argument for the polar view is that swaps are commercial, not investment, transactions of a type the securities laws were not designed to cover. However, this argument inappropriately merges the swap transaction into the underlying debt transaction as a bootstrap. A less convincing argument posits that the swap agreement is a mere bilateral contract which, because it is not assignable without the counterparty's consent, cannot be deemed a security. This argument ignores the fact that many "securities" are evidenced by nonassignable contracts (e.g., limited partnership interests). Further, the very existence of a large and liquid secondary swap market destroys this argument.

123. Section 3 of the 1933 Act, 15 U.S.C. § 77c (1982), generally exempts municipal and bank securities; commercial paper with a maturity not exceeding nine months; securities of charitable organizations; savings and loan association securities; securities of common carriers; receiver and trustee certificates; insurance policies; securities exchanged with security holders of the same issuer; and securities that are offered and sold only to residents of a single state. Although found in § 3 of the 1933 Act, which lists exempt securities, the last category is actually a transactional exemption.

124. Section 4 of the 1933 Act, 15 U.S.C. § 77d(2) (1982) exempts transactions by persons other than issuers, underwriters, and dealers; "private" offerings; dealer transactions; broker transactions; securities originated by certain mortgages; and offers or sales solely to accredited investors.

125. Section 4(2) of the 1933 Act, 15 U.S.C. § 77d(2) (1980) exempts "transactions by an issuer not involving any public offering."

126. See SEC v. Ralston Purina Co., 346 U.S. 119 (1953); H. BLOOMENTHAL, *supra* note 111, § 4.05[1].

127. See H. BLOOMENTHAL, *supra* note 111, § 4.05[1].

the Court declared that a "private offering" was characterized by the offer of the security to no more than a limited group of individuals;¹²⁸ the ability of an offeree to "fend for itself";¹²⁹ the offeree's access to the same kind of information about the offeror that would be disclosed in a registration statement;¹³⁰ and the absence of general solicitation or advertising.¹³¹ For issuers and counsel rendering legal opinions, the section 4(2) exemption was a constant trap for the unwary, due to imprecise compliance standards.

The Securities and Exchange Commission has attempted to ameliorate this situation by promulgating first Rule 146¹³² in 1972 and then Regulation D¹³³ in 1982. These regulatory "safe harbors" from registration¹³⁴ were not designed or intended to supplant the law that had developed under section 4(2).¹³⁵ Under the case law, the corporate participant in a large commercial financing transaction is presumed able to fend for itself, and, by virtue of its size and financial resources, is presumed to be in a sufficiently strong economic bargaining position to have access to all of the information that registration would disclose.¹³⁶ Therefore, financial institutions and large corporations that engage in "private" securities transactions have continued to rely upon the exemption provided by the

128. *Ralston Purina*, 346 U.S. 119 (the Court noted that the size of the group is not conclusive, but is a relevant factor).

129. *Id.* at 125.

130. *Id.* at 125-26.

131. *Id.* at 124 (although the lower court relied on the absence of general solicitation or advertising in rendering its opinion in *Ralston Purina*, the Supreme Court did not expressly address the significance of this factor).

132. Adopted in SEC Rel. No. 33-5487 (Apr. 23, 1974), 39 F.R. 15261 (1974) (codified at 17 C.F.R. §230.146 but removed, effective Jun. 30, 1982).

133. Adopted in SEC Rel. No. 33-6389 (Apr. 15, 1982), 47 F.R. 54764 (1982). Although adopted under § 3(b) of the 1933 Act, which gives the SEC broad discretionary power to exempt securities issued as part of an issue involving less than \$5 million, Regulation D is in fact a "safe-harbor" for the exemption under § 4(2).

134. By "safe harbor," the SEC means that if all conditions of such a rule are met, compliance with the underlying statutory exemption is assured.

135. By their express terms, none of the "safe harbor" exemptions is the exclusive route to the statutory exemptions, as interpreted by the courts, under which such safe harbors were promulgated.

136. This presumption might not be valid when the concern is access by a savings institution to all the information registration would disclose about a large, publicly-held corporation. Access to information can be presumed from position with the issuer, as in the case of an executive officer, or economic bargaining power, as in the case of a large financial institution on whom the issuer is dependent. It is important to note in this context that access to all of the information that registration would disclose does not mean that such information is actually disclosed to the offeree of the security: it requires only that the person have access to the information, notwithstanding any failure to request it or have it provided voluntarily.

courts' interpretation of the statute, and not on the SEC's safe harbor rules.

Interest rate swap transactions clearly make a strong claim to the exemption provided by section 4(2).¹³⁷ First, the swap is offered to a limited number of offerees. Second, the swap is not generally solicited or advertised. Third, the participants are financial institutions and corporations which the courts presume are able to fend for themselves. And fourth, the courts presume that these participants have access to the information that the registration statement would disclose. However, as smaller-scale investors begin to participate in swaps, these transactions may raise serious exemption questions at some time in the future. Nevertheless, given the current and likely future participants, the section 4(2) exemption from registration should be applicable in nearly all cases.

C. *The Antifraud Rules*

Notwithstanding the availability of an exemption from registration under the Act, an interest rate swap transaction, as a security or an interest in a security, is nevertheless subject to the antifraud rules under both the 1933 and 1934 Acts.¹³⁸ Until 1976, Rule 10b-5 under the 1934 Act had developed into a substantive body of federal corporate law so that applicability of the rule was a grave danger in transactions remotely connected to the purchase and sale of a security.

The Supreme Court's decision in *Hochfelder*¹³⁹ in 1976, and similar decisions which restricted the applicability of Rule 10b-5,¹⁴⁰ considerably diminished access to the rule as a cause of action for fraud under the securities laws.¹⁴¹ Specifically, with regard to interest rate swap transactions among corporations and financial institutions, a claim under Rule 10b-5 seems unlikely, given that the rule

137. Most participants would likely claim the statutory exemption rather than attempt to comply with a safe harbor from registration.

138. An exempt security or transaction is exempt only from the registration requirement imposed by § 5 of the 1933 Act. No exemption from the antifraud rules is concurrently afforded the security or transaction.

139. *Ernst & Ernst v. Hochfelder*, 429 U.S. 185 (1976). For a discussion of the *Hochfelder* case, see H. BLOOMENTHAL, *supra* note 111, § 9.21[4].

140. In *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), the Second Circuit held that only a purchaser or seller could maintain a cause of action under Rule 10b-5. After this decision was riddled with exceptions, or completely repudiated, by the circuit courts for two decades, the Supreme Court emphatically reaffirmed the *Birnbaum* rule in *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975).

141. See A. JACOBS, *supra* note 117.

requires proof of scienter, or an active and willful intent to defraud.¹⁴² The antifraud rules in the Act, however, could provide a corporate swap partner with a legitimate cause of action against the counterparty to the swap, if it is shown that the corporate swap partner invested funds and assumed a credit risk based on a misstatement of a material fact regarding the financial condition of the counterparty to the swap or on an omission to state such a material fact.¹⁴³

VI. CONCLUSION

Interest rate swaps have thus far been mostly an esoteric hedging and financing vehicle for the largest and most sophisticated corporate and financial institutions. Scant mention has been made in the literature of the possible securities law ramifications of these transactions. Discussions of proper tax or accounting treatment have universally alluded to what the participants "are doing," or to the treatment which participants' accountants have thought most sensible, absent any clear guidelines. We have suggested an approach to each major issue based largely upon existing, analogous transactions, with heavy reliance upon the economic substance of interest rate swaps, as opposed to the quite narrow, and often specious, analysis that is suggested in the literature dealing with this important and growing market.

By concluding that swap contracts are securities and that their tax treatment should, like analogous commodity futures transactions, depend principally upon the investment motives of the participants, we have attempted to bring this largely unregulated type of transaction into a sympathetic yet demanding analytical realm. We believe strongly that the growing interest rate swap phenomenon is an important adjunct to debt financing in the industrial, commercial, and financial markets. By subjecting it to legitimate analysis, we hope to further its legitimate and valuable purposes.

142. The *Hochfelder* requirement that the misstatement or omission be intentional to support the requisite degree of scienter was subsequently stretched to include reckless behavior and an extreme departure from the standards of ordinary care. See *Herzfeld v. Lanenthol, Krekstein, Horwath & Horwath*, 540 F.2d 27 (2d Cir. 1976); *McLean v. Alexander*, 420 F. Supp. 1057 (D. Del. 1976).

143. For example, to support a cause of action under § 12(2) of the 1933 Act, the plaintiff need only prove the purchase of a security, use of a jurisdictional plan, and a false or misleading statement in connection with the sale of the security. See, e.g., *H. BLOOMENTHAL*, *supra* note 111, § 8.05.

Ultimately, the SEC, the Service, and the courts will put the interest rate swap into its appropriate legal pigeonholes, or perhaps Congress will address these issues. In either case, we hope that these ultimate arbiters will share our appreciation for these marvelously simple and useful financing tools, and not be too swayed by our conclusions—conclusions that relate only to the law as it exists today.